

investments in property, plant and equipment as we continue to invest in our wireless network and due to the amortization of our customer base recorded in the partial step-up in basis recorded in accordance with the purchase accounting provisions of EITF 88-16. Amortization expense was also increased by a non-recurring charge for the cost of a portion of a personal communications service license that will not be developed and therefore a \$6.5 million charge was recorded in March 1999.

**INTEREST EXPENSE, NET.** On a consolidated basis, we incurred interest expense of \$28.9 million in the six-month period ended June 30, 1999, substantially all of which was attributable to interest on debt of \$1,591 million incurred on March 2, 1999 in connection with the acquisition of control of Telecomunicaciones de Puerto Rico. We had no material debt or interest expense during the six-month period ended June 30, 1998.

**EXTRAORDINARY CHARGE.** During 1996, the Government of the Commonwealth of Puerto Rico enacted the Federal Telecommunications Act of 1996 and began the process of deregulating the formerly restricted markets for telecommunications services in Puerto Rico to open them to competition. This action was taken to bring the benefits of competition to consumers of telecommunications services and to stimulate investment in advanced technology and new telecommunications services. Additionally, competition in the intra-island long distance market increased on February 1, 1999, when the requirement to dial additional numbers was eliminated in order to give equal access dialing to all of our competitors, as mandated by the FCC. This deregulation process concluded with the privatization of Telecomunicaciones de Puerto Rico through the acquisition of control of Telecomunicaciones de Puerto Rico by the GTE Group.

Prior to the acquisition, Puerto Rico Telephone Company rates were based upon the cost of providing services including a return on capital deployed. Further competition in its markets was restricted and Puerto Rico Telephone Company maintained a monopoly position in providing telecommunications services. These factors provided sufficient assurance that the costs of investments in property, plant and equipment would be recovered through the ratemaking process. Accordingly, the technological changes in the provision of

34

&lt;PAGE&gt; 38

telecommunications services that resulted in a reduction in the economic life of Puerto Rico Telephone Company telecommunications plant and equipment were not reflected in the depreciation expense used in the ratemaking process on a timely basis. Deferral of cost recovery did not require an increase in depreciation expense for financial reporting purposes as future cost recovery was assured through the ratemaking process as permitted by the application of the provisions of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation." With the deregulation of the operations of Telecomunicaciones de Puerto Rico and the opening of Puerto Rico's telecommunications markets to competition this assurance no longer exists. Puerto Rico Telephone Company has therefore discontinued SFAS No. 71 and recorded a reduction in the value of its property, plant and equipment that is not expected to be recoverable through future operations over its remaining service life. Fifty percent of this asset impairment, reflecting the portion of Telecomunicaciones de Puerto Rico acquired by the GTE Group, was reflected as part of the proportional purchase price adjustment reflecting the estimated fair market value of these assets. The remaining portion was recorded as a non-cash, nonrecurring, extraordinary charge to expense of \$60.5 million, net of tax benefits of \$38.8 million, in March 1999.

**INCOME TAXES.** In the six-month period ended June 30, 1999, we recorded \$11.7 million in income tax expenses applicable to taxable transactions recorded in the measurement of income. Prior to our privatization on March 2, 1999 we were not subject to income taxes.

NET INCOME. For the reasons discussed above, the Company had a net loss of \$38.2 million for the six months ended June 30, 1999 compared to net income of \$135.9 million for the same period in 1998. The net loss for the period March 2 through June 30, 1999 was 40.1 million. As noted above, the 1999 period included an after-tax extraordinary charge of \$60.5 million due to the discontinuance of SFAS No. 71.

We believe that the results for the second quarter are not necessarily indicative of our results for the remainder of the year because of the special nature of certain of the charges incurred during the first and second quarters of 1999 and because of the change in our basis of accounting.

#### Hurricane Georges

On September 21, 1998, Hurricane Georges struck Puerto Rico and caused considerable property damage to our service area in general, including our telecommunications systems. Our expenses in the six-month period ended June 30, 1999 were higher than in the same period in 1998 in part because of approximately \$28 million of higher maintenance and labor expenses attributable to repairing damage caused by Hurricane Georges.

In addition to the expenses incurred in the first and second quarters of 1999, we lost revenues and incurred expenses in 1998 due to Hurricane Georges. As a result of the hurricane, we:

- believe that we lost approximately \$18.6 million in revenues in 1998 because of lines out of service from September to December;
- incurred hurricane-related expenses of \$31.7 million in 1998, of which \$18.1 million was due to repairs included in operating expenses, and \$13.6 million charged to depreciation expense;
- incurred capital expenditures of \$30.5 million for the replacement of destroyed property;
- were unable to dedicate resources to install new access lines, particularly after the 41-day work stoppage in the second quarter of 1998 to protest the privatization; and
- recorded as other income, amounts received from insurance claims of approximately \$6.4 million.

We believe that substantially all of the repair work caused by Hurricane Georges has now been completed.

35

<PAGE> 39

#### YEAR ENDED DECEMBER 31, 1998 COMPARED WITH YEAR ENDED DECEMBER 31, 1997

REVENUE AND SALES. We reported a revenue increase in 1998. Our Wireline and Wireless revenues increased \$37 million, or 3%, to \$1,271 million for 1998 from \$1,234 million for 1997. The increase resulted primarily from growth in local service and access revenues.

#### Wireline:

In 1998, local service revenues increased \$21 million, or 5%, to \$468 million for 1998 from \$447 million for 1997. The increase was primarily due to growth in value added services, such as caller I.D. and call waiting, which produced \$8.0 million of higher basic voice service revenue; growth in the number of access lines, which produced a \$9.6 million increase in rental revenues from business and residential lines; additional usage revenues of \$6.0 million and an increase in Internet revenues of \$2.5 million, in each case as

compared with 1997 revenues. Revenues from lines and installation charges declined in 1998.

Access line growth in 1998 was only 0.8%, a substantial decrease in the growth rate when compared to the growth rate for the preceding three years, which ranged from 4% to 6%. The lower growth rate was primarily attributable to Hurricane Georges and a 41-day work stoppage organized to protest the privatization of our company. The waiting list of orders for new installations increased to 36,600 at December 31, 1998 because we were inhibited from deploying service after the work stoppage during the summer and because our efforts in the fourth quarter were devoted primarily to restoring service in the areas adversely affected by Hurricane Georges.

Network access revenues increased by \$22 million, or 8%, to \$300 million for 1998 from \$278 million for 1997. The increase resulted primarily from \$21 million of higher universal support subsidies administered by the National Exchange Carrier Association. These subsidies are derived from pooling arrangements with other U.S. exchange carriers that generate end-user interstate revenues. The pooled amounts are subsequently divided among the various telephone companies based upon their respective estimated allocations of costs and investments in providing interstate services. The amount received in 1998 was higher than in prior years because we incurred certain non-recurring costs, which are included when calculating the amount of this support. In addition, higher revenues of \$4 million in access charges paid to us by on-island long distance competitors contributed to the increase in access revenues.

Long distance revenues remained constant for 1998 at \$252 million, with an increase in on-island long distance revenues of \$6 million over 1997 levels offset by a reduction in toll private lines, toll-free services and wide area telecommunications services revenues. On-island long distance minutes increased by 1% in 1998, from 1,649 million minutes in 1997 to 1,670 million minutes in 1998. This increase was limited as a result of lines being out of service during the 41-day work stoppage, Hurricane Georges and increased competition. We adopted a new rate structure in April 1998, which produced slightly higher average revenue per minute from \$0.13 in 1997 to \$0.14 in 1998.

Directory services and other revenues decreased by \$9 million, or 9%, to \$91 million for 1998 from \$100 million for 1997. The decrease resulted from a decline in the revenues generated in connection with the directory service revenue sharing agreement, which expires with the production of directories for 1999. See "Business -- Directory." In addition, the decrease in other revenues resulted primarily from a decrease in equipment sales because of a larger than normal equipment sales contract with the Puerto Rico Police Department in 1997.

#### Wireless:

Cellular revenues decreased \$2 million, or 2%, to \$100 million for 1998 from \$102 million for 1997, despite an increase of 69,000 customers to 204,000 at year-end 1998 from 135,000 at year-end 1997. Approximately 48,000 of the 69,000 new customers were prepaid customers who generate substantially lower average revenue per unit than regular customers due to lower average minutes of use per customer. Monthly average revenue per unit averaged \$49 in 1998, a decrease of \$10 from 1997. The decline in average revenues

36

<PAGE> 40

for regular accounts was caused by the addition of the prepaid customers and lower-end regular subscribers in a more competitive market environment.

Paging revenues continued to grow in 1998, increasing by \$5 million, or 9%, to \$60 million for 1998 from \$55 million for 1997, as a result of an increase of 20% in average prices offset in part by a decrease in the number of customers which was caused by our stricter collection policies.

**OPERATING COSTS AND EXPENSES.** Total Wireline and Wireless costs and expenses for 1998 increased by \$54 million, or 5.4%, to \$1,044 million from the \$990 million reported for 1997.

**Wireline:**

Total Wireline costs and expenses for 1998 increased \$55 million, or 6.5%, to \$907 million from the \$852 million reported for 1997. Cost of services and sales were \$460 million, or \$29 million higher, than the \$431 million reported in 1997, primarily due to non-recurring restoration costs related to damage caused by Hurricane Georges. Interconnection charges paid for the first time to wireless providers in 1998 also contributed \$13 million to the increase. Selling, general and administrative expenses were \$172 million, or 8.1%, higher than the \$159 million reported for 1997. Consulting and commission fees also contributed to the increase.

**Wireless:**

Total Wireless costs and expenses for 1998 of \$137 million reflected a slight reduction of \$1 million as compared to the \$138 million recorded in 1997.

Cost of services and sales increased \$4 million, or 21% to \$23 million primarily due to the increase in cost of goods sold resulting from the growth of 69,000 new subscribers activated during 1998. Selling, general and administrative expenses decreased \$9 million, or 9% in 1998 to \$92 million from the \$101 million reported in 1998, primarily due to reductions of \$4 million in access charges.

**Depreciation and Amortization Expense.** Consolidated depreciation and amortization expense increased by \$18 million, or 6%, to \$297 million for 1998 from \$279 million for 1997 due to higher levels of gross plant in service.

**Net Income.** For the reasons set forth above, consolidated net income decreased \$22 million, or 9%, to \$224 million for 1998 from \$246 million for 1997. As noted above, the 1998 period included \$18 million of Hurricane Georges restoration costs and an estimated \$5 million of incremental costs associated with the 41-day work stoppage.

**YEAR ENDED DECEMBER 31, 1997 COMPARED WITH YEAR ENDED DECEMBER 31, 1996**

**REVENUES AND SALES.** Total Wireline and Wireless revenue increased \$33 million, or 3%, to \$1,234 million for 1997 from \$1,201 million for 1996. The increase resulted primarily from the growth in local, paging and access revenues.

**Wireline:**

Local revenues increased \$28 million, or 7%, to \$447 million for 1997 from \$419 million for 1996. The increase was due to the expansion of the number of access lines, which produced higher revenues for basic voice services of \$17 million. In addition, private branch exchange rental revenues increased \$2 million and revenue from value-added services was \$8 million, or 38%, higher than the prior year because of strong demand for such services. Access lines increased by 5.6% in 1997.

Long distance revenues decreased \$11 million, or 4%, to \$252 million for 1997 from \$263 million for 1996. The decrease was driven by the full year effect of the August 1996 price reductions associated with dial-around competition. Prices decreased from a \$0.16 average in 1996 to a \$0.13 average in 1997. Traffic volume increased, however, with a 13% increase in minutes, from 1,464 million minutes in 1996 to 1,649 million minutes in 1997.

&lt;PAGE&gt; 41

Network access revenues increased \$20 million, or 8%, to \$278 million for 1997 from \$258 million for 1996. The increase was driven by an increase in switched access revenues and higher long-term support subsidies principally because we were required to provide higher cost services than other pool participants.

Directory services and other revenues increased by \$8 million, or 9%, to \$100 million for 1997 from \$92 million in 1996. Main increases were in the other revenue category as a result of a large equipment sales contract with the Puerto Rico Police Department.

Wireless:

Cellular revenues decreased \$33 million, or 24%, to \$102 million for 1997 from \$135 million for 1996, due to a net reduction of 18,000 customers, from 153,000 to 135,000, and reductions in monthly average revenue per unit, to \$59 in 1997 from \$71 in 1996. The customer loss was due to customer terminations resulting from network fraud and the associated inability to roam in the continental U.S. Mainland carriers would not permit roaming because of concerns regarding our problems with fraudulent phone usage. In addition, our stricter credit and collection procedures contributed to the net loss of customers. We addressed our fraud problems in late 1997 through the implementation of authentication-fingerprinting software.

Paging revenues increased significantly to \$55 million in 1997 from \$34 million in 1996, a 62% increase, resulting from an 18% increase in customers and an increase in monthly average revenue per unit from \$17 in 1996 to \$21 in 1997. Paging customers grew from 200,000 in December 1996 to 235,000 in December 1997.

OPERATING COSTS AND EXPENSES. Total Wireline and Wireless costs and expenses for 1997 decreased \$71 million, or 7%, to \$990 million from the \$1.1 billion reported in 1996.

Wireline:

Total costs and expenses for the Wireline segment decreased \$77 million, or 8%, to \$852 million from the \$929 million reported in 1997. Cost of services and sales decreased \$14 million, or 3%, million to \$431 million. Selling, general and administrative expenses decreased \$84 million, or 35%, to \$159 million. Reductions in cost of services and sales as well as selling, general and administrative were mainly due to the one-time charge of \$99 million associated to an early retirement program offered in 1996. This resulted in an improvement in access lines per Wireline employee to 135 in 1997 from 153 in 1996.

Wireless:

Total Wireless costs and expenses for the year 1997 increased \$6 million, or 4.5%, to \$138 million from the \$132 million reported in 1996. Costs of services and sales decreased \$5 million, or 21%, to \$19 million primarily due to the reduction in cost of good sold associated to the decrease of lines in service from 153,000 in 1996 to 135,000 in 1997. Selling, general and administrative costs increased \$7 million, or 7%, to \$101 million from the \$94 million reported in 1996, primarily due to an increase in operator services for paging.

Depreciation and Amortization Expense. Consolidated depreciation and amortization expense increased \$25 million, or 10%, to \$279 million for 1997 from \$255 million for 1996 due to higher levels of gross plant in service and the amortization of \$4 million related to the acquisition cost of the personal communications system licenses.

Net Income. As a result of all of the above, net income increased \$104

million, or 73%, to \$246 million for 1997 from \$142 million for 1996. As noted above, the 1996 period included \$99 million of charges for an early retirement program.

#### LIQUIDITY AND CAPITAL RESOURCES

As of December 31, 1998, we had working capital of \$88 million, compared to \$136 million and \$131 million for 1997 and 1996, respectively. Accounts payable and accrued expenses increased substantially at December 31, 1998 due to planned capital additions and replacement and restoration activities totaling approximately \$49 million accrued late in the fourth quarter of 1998. We delayed our capital expenditures

38

<PAGE> 42

program, first because of the 41-day work stoppage which ended by early August 1998 and then because of Hurricane Georges on September 21, 1998. This increase in accounts payables was partially offset by an increase in accounts receivables primarily attributable to delays in billing and collections caused by Hurricane Georges.

As of June 30, 1999, we had working capital of \$98.3 million compared to working capital of \$88.1 million at December 31, 1998.

As part of the closing of the acquisition of Telecomunicaciones de Puerto Rico by the GTE Group, we distributed \$1,570.2 million in cash to a Puerto Rico Telephone Authority as a special dividend on March 2, 1999. We borrowed \$1,591.1 million under our bank credit facilities at the closing of the acquisition, of which \$1,565 million was used to pay the special dividend and \$26.1 million was used to make a loan to the employee stock ownership plan to purchase 3% of our shares. We used \$5.2 million of cash on hand to pay a portion of the special dividend. Cash and cash equivalents were \$36 million at December 31, 1998, compared with \$21 million and \$43 million for 1997 and 1996, respectively. Prior to the acquisition, our predecessors distributed to the Puerto Rico Telephone Authority cash dividends in an amount equal to net income plus depreciation and amortization on the tenth day of each month. Cash balances at any balance sheet date therefore represented net cash receipts for an approximate 20-day period. As of June 30, 1999, cash and cash equivalents increased to \$63.7 million because no cash dividend distributions were made to the Puerto Rico Telephone Authority after the acquisition.

At June 30, 1999, we had \$174 million available under a \$200 million revolving credit facility with Banco Popular entered into in connection with the acquisition.

Cash from operations for the six-month period ended June 30, 1999 was \$179.6 million compared to cash from operations for the six months ended June 30, 1998 of \$272.8 million. The decrease in cash from operations of \$93.2 million is primarily attributed to higher operating expenses, which included \$28 million for repair expenses associated with Hurricane Georges. Cash expended for investment activity for the six months ended June 30, 1999 was \$100.3 million compared to cash expended for investment activity of \$106 million for the six months ended June 30, 1998. We have continued our capital spending programs to enhance the technological capability of our network to provide new products and services to our customers to stay competitive.

Net cash from operations of \$614 million in 1998 was \$106 million and \$110 million higher than 1997 and 1996, respectively. Internally generated funds have been sufficient to fund capital expenditures of \$288 million, \$362.2 million and \$391 million for the years 1998, 1997 and 1996, respectively. We expect to spend \$1.2 billion under our five-year capital expenditure plan for the years 1999 through 2003 financed through internal and externally generated funds and we have publicly committed to spend at least \$1.0 billion on capital expenditures

during the same five-year period. Our capital expenditure budget for 1999 totals approximately \$224 million.

We had unfunded pension and other postretirement liabilities aggregating \$433 million as of December 31, 1998. We will reduce this liability with internally generated funds, \$200 million in capital contributions from the Puerto Rico Telephone Authority and estimated tax savings of \$128 million associated with using the \$200 million to pay such liabilities. The Puerto Rico Telephone Authority is contractually obligated to contribute \$40 million in cash in 2000 and 2001 and in either cash or shares of Telecomunicaciones de Puerto Rico stock for the next three years to reduce these unfunded pension and postretirement liabilities. We are contractually obligated to apply these proceeds plus the grossed-up effect of the tax deduction totaling \$66 million per year, regardless of whether the Puerto Rico Telephone Authority exercises its share payment option. We believe the Puerto Rico Telephone Authority will make those contributions in cash because a total of \$175 million of certificates of deposit issued by the Government Development Bank for Puerto Rico and agency debentures issued by the Federal Home Loan Bank were placed in escrow to secure this obligation.

We expect to fund our interest payment obligations and capital expenditure plan with internally generated funds and to fund principal payment obligations through a combination of internally generated funds and refinancings.

39

&lt;PAGE&gt; 43

In connection with the acquisition, our shareholders agreed that the common shares of Telecomunicaciones de Puerto Rico will bear a dividend, payable on a quarterly basis, to the extent funds are legally available, and subject to any restrictions imposed by any financing, that is at least equal to 50% of our consolidated net income. The indenture for the old notes and the exchange notes and our credit facilities do not contain dividend restrictions.

#### REGULATORY AND COMPETITIVE TRENDS

During the second quarter of 1999, regulatory and legislative activity at both the state and federal levels continued to be a direct result of the Federal Telecommunications Act of 1996. Along with promoting competition in all segments of the telecommunications industry, the Telecommunications Act was intended to preserve and advance universal service.

We continued in the second quarter of 1999, to meet the wholesale requirements of new competitors. To date, we have signed over 20 interconnection agreements with other carriers, providing them the capability to purchase individual unbundled network elements, resell retail services and interconnect facilities-based networks. Several of these interconnection agreements were the result of the arbitration process established by the Telecommunications Act, and incorporated prices or terms and conditions based upon the Federal Communications Commission rules that were subsequently overturned by the Eighth Circuit Court in July 1997.

Concurrent with our competitors entry in the markets, as a result of a change in the regulatory environment, we have continued our expansion into local, long-distance, Internet-access, wireless and video services both within and outside our traditional operating areas.

#### IMPACT OF RECENT ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," which established accounting and reporting standards for derivative instruments and hedging instruments. SFAS No. 133, as amended by SFAS No. 137, is effective January 1, 2001. The statement requires entities that use derivative instruments

to measure and record these instruments at fair value as assets or liabilities on the balance sheet. It also requires entities to reflect the gains or losses associated with changes in the fair value of these derivatives, either in earnings or as a separate component of comprehensive income, depending on the nature of the underlying contract or transaction. We do not currently utilize derivative instruments. Therefore, the adoption of SFAS No. 133 is not expected to have a significant effect on our results of operations or our financial condition.

In March 1998, the American Institute of Certified Accountants issued Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." Under the provisions of this Statement of Position, effective January 1, 1999, we capitalize and amortize the cost of all internal-use software, including network-related software.

#### RECENT INTERNET REGULATORY ACTION

The FCC has been considering issues relating to whether Internet traffic is subject to carrier-to-carrier reciprocal compensation arrangements. These arrangements provide for the payment of compensation to a local telephone company for transporting and terminating a local call that is placed by one of its competitor's customers. There is an ongoing dispute in the telephone industry over whether calls from wireline phones of one local exchange carrier to Internet service providers served by a different local exchange carrier are subject to reciprocal compensation.

Many incumbent local telephone companies, like us, argue that calls to Internet service providers are interstate in nature because the call originates in one state and may terminate in another state, in a foreign country or has mixed termination. In other words, with just one call to the Internet service provider the caller may access different local, interstate and foreign points.

40

<PAGE> 44

On February 26, 1999, the FCC released a Declaratory Ruling regarding this issue. In that ruling the FCC concluded that carriers are bound by their existing interconnection agreements, as interpreted by state commissions, and thus are subject to reciprocal compensation obligations to the extent provided by such agreements or as determined by state commissions. The FCC also declared that Internet traffic is jurisdictionally mixed but appears to be largely interstate in nature, and thus subject to federal jurisdiction. The FCC concluded that the calls at issue do not terminate at the Internet service provider's local servers, but continue to their ultimate destinations, at websites that are often located in other states or countries. The decision also preserves the rule that exempts the Internet and other information services from the payment of interstate access charges.

The FCC tentatively concluded that inter-carrier compensation for said interstate traffic should be governed prospectively by interconnection agreements negotiated pursuant to the provisions of the Federal Telecommunications Act of 1996. It has also launched a proceeding to determine an appropriate compensation scheme for such calls in the future.

The Telecommunications Regulatory Board of Puerto Rico had not approved, prior to the FCC ruling, any agreement regarding how Internet traffic was to be compensated in Puerto Rico. However, on September 28, 1999 an arbitrator issued a Report and Order in the PRTC/Sprint arbitration proceeding in which she found that traffic originated in Puerto Rico and bound for an Internet service provider should be considered interstate traffic not subject to reciprocal compensation. With respect to our operations, the Regulatory Board has approved new interconnection agreements with Lambda and Centennial. Those agreements state that traffic originated in Puerto Rico to an Internet service provider shall not be subject to reciprocal compensation, but the parties also agreed



that the execution of the interconnection agreements did not constitute a waiver of any rights the parties may have to seek compensation for such traffic in any appropriate forum. Lambda/Centennial filed a motion for the reconsideration of the Board Resolution and Order approving the interconnection agreements. The Regulatory Board has issued an order upholding its previous resolution and order.

We at present do not pay reciprocal compensation for calls to Internet service providers. We, however, have exercised our rights under the previous Lambda/Centennial interconnection agreements to conduct an audit to determine the volume of local and interexchange (intrastate and interstate) traffic routed between the parties' networks to determine the validity of the payments made by the parties during the term of those agreements. In April 1999, Lambda/Centennial filed an FCC tariff establishing a charge for calls made by customers of Puerto Rico Telephone Company to an Internet service provider served by Lambda/Centennial. We have withheld payments on the billings we have received from Lambda/Centennial with regard to these calls.

We are also in the process of negotiating an interconnection agreement with Sprint for which both parties have filed an arbitration petition before the Regulatory Board. As stated above, the arbitrator issued her Report and Order with regard to this matter on September 28, 1999. The arbitrator resolved disputed issues and ordered the parties to file an interconnection agreement consistent with her findings by October 13, 1999. The parties have filed an interconnection agreement with the Regulatory Board and have the right to file motions to petition for the reconsideration of any of the issues decided by the arbitrator after the Regulatory Board issues an order approving the interconnection agreement.

#### FACTORS AFFECTING OUR FUTURE FINANCIAL RESULTS

As a result of the acquisition, our reported results of operations and financial condition for periods ended since the acquisition differ materially from reported periods ended prior to the acquisition.

These changes derive principally from:

- a change from being a government-owned entity which did not pay taxes, other than excise and in lieu of taxes, to a privately owned company which will pay taxes;
- the incurrence of \$1,591.1 million of debt in connection with the acquisition;
- the creation of an employee stock ownership plan owning 7% of our shares;

41

<PAGE> 45

- our obligation to pay management fees and a technology license royalty to subsidiaries of GTE, the cash payment of which will be deferred, with interest, until at least March 2, 2000;
- the reduction of under-funded pension plan liabilities and other post-retirement liabilities through the capital contributions that will be made by the Puerto Rico Telephone Authority over the next five years;
- our voluntary separation plan which became effective in June 1999 for the early retirement of employees;
- the loss of National Exchange Carrier Association-administered long-term support and the adoption of price cap interstate access formulae during the first half of 2000 and a possible change in the amounts of universal service fund subsidies;

- increasing competition and changes in the regulatory environment in Puerto Rico, such as the implementation of dialing parity for on-island long distance calls on February 1, 1999; which will make it easier for our customers to use the facilities of competitors;
- our offering of off-island long distance service as a result of the termination of certain mutual non-competition covenants with Telefonica Larga Distancia;
- the changes in regulation affecting our operations and the introduction of competition which has resulted in our discontinuation of regulatory accounting principles; and
- the adoption of a new basis of accounting to reflect the acquisition which results in an increase in the assets and shareholders' equity components of our financial position. These assets will be amortized to expense in the measurement of future results of operations as they are realized.

Prior to the acquisition, Puerto Rico Telephone Company distributed to the Puerto Rico Telephone Authority as a cash dividend an amount equal to its net income plus amortization and depreciation. The Puerto Rico Telephone Authority used the proceeds to service its debt and make payments in lieu of taxes to governmental authorities in Puerto Rico. After the acquisition, we will report substantially higher expenses for the direct payment of taxes as a result of being a private company. We do not expect to have a cash income tax liability for 1999. Based on a maximum statutory income tax rate of 39%, we would have paid \$67.2 million in income taxes on our 1998 results. Following the acquisition, we must also pay property, municipal and unemployment taxes. Based on 1998 results, we would have paid \$52 million in such taxes.

We expect that our future income tax liability will be reduced annually by an amount arising from a step-up of the tax basis of our assets and liabilities to their fair values established in the acquisition. The estimated \$475 million step-up, representing the excess of the purchase price paid versus the net book value of the assets, will be amortized as a deduction for income tax purposes over 15 years. These amortizations when combined with the future tax deductions of funding prior employee benefit costs and depreciation of property, plant and equipment will produce future tax cash benefits. These future tax benefits have been recorded as a deferred tax asset on our balance sheet with an increase in equity. We have received a favorable ruling from the government of Puerto Rico regarding the ability to step-up the assets to the values established in the acquisition and deduct prior employee benefits costs funded.

In connection with the acquisition, we incurred \$1,591.1 million of debt. Assuming we incurred the debt on January 1, 1998 and calculating interest at an effective interest rate of 6.37%, which was the average rate at the acquisition date, we would have had approximately \$100.4 million in interest expense in 1998.

We created the employee stock ownership plan on the date of the acquisition and allocated 70,000 shares to the trust for the benefit of employees. The 7% of our shares acquired by the employee stock ownership plan were valued at \$60.9 million. The employee stock ownership plan allocation consists of three elements, discussed below.

- A grant from the Puerto Rico Telephone Authority of 30,000 shares, representing 3% of our shares, valued at \$26.1 million. The grant vested immediately and the \$26.1 million non-cash amount was recorded as an operating expense on March 1, 1999 by the predecessors;

- A grant from the GTE Group of 10,000 shares, representing 1% of our shares, valued at \$8.7 million. The GTE Group grant was valued at \$8.7 million, and recorded as deferred compensation on March 2, 1999 and was credited to paid-in-capital with no effect on shareholders' equity. The deferred compensation amount will be charged to earnings in future periods when these shares vest; and
- A purchase by the employee stock ownership plan of 30,000 shares, representing 3% of our shares, with the proceeds of a loan from us in the amount of \$26.1 million. The shares will be recorded by us as an operating expense over a period not to exceed 20 years as these shares are released to the employees.

We are obligated to pay subsidiaries of GTE management fees and a technology license royalty aggregating 8% of EBITDA, or approximately \$38 million based on pro forma 1998 EBITDA of \$475.5 million prior to payment of the management fee. The aggregate fee declines to 7% of EBITDA in 2002 and 2003 and to 6% of EBITDA in 2004. The GTE subsidiaries have agreed to defer, with interest, the payment of such fees and royalty until at least March 2, 2000.

We have introduced a voluntary early retirement program to our workforce to reduce expenses and streamline operations. The program involves providing an incentive equal to adding five years of age and five years of service in the calculation of pension benefits for employees that reach a minimum of years of age and service threshold. Employees accepting retirement will also be entitled to normal medical and life insurance benefits.

The program was offered to our non-union salaried workforce in June 1999 and 273 employees accepted early retirement in July 1999. A provision of approximately \$83 million will be recorded in the third quarter of 1999 associated with this program. We have recently reached terms on a program with our unions. The first union involving approximately 600 employees must accept the offering in September 1999, whereas the second union involving 200 employees must accept the offering in October 1999. Based on expected acceptance rates, the cost associated with the union offerings is estimated to range from \$30 million to \$45 million each. Approximately \$25 million associated with the total cost for the union and non-union offering involves an immediate cash obligation.

Prior to the acquisition, our rates were regulated on a rate-of-return/cost of services basis entitled to financial support from subsidy pools administered by National Exchange Carrier Association. As a rate-of-return carrier, we were permitted to charge prices sufficient to cover our costs and to provide an annual rate of return of up to 11.5%. We were also entitled to long-term support subsidies for operating in high cost areas which provided the funds to achieve this return. After the acquisition, we will be considered a price cap carrier. As a price cap carrier, our prices, rather than our costs and earnings, will be regulated. We must exit the long term support pool in the first half of 2000 and implement a price cap mechanism related to the recovery of common carrier line and traffic sensitive costs. When we exit the pool, we will be able to charge interexchange carriers a pre-subscribed interexchange common carrier line charge which is assessed on an access line basis for interconnection to our local network. We received \$91 million in long-term support in 1998. Based on existing pre-subscribed interexchange common carrier line charge rates established by the FCC for all local exchange carriers and our estimates of projected access lines, we expect to receive annualized pre-subscribed interexchange common carrier line charge revenues of \$33 million in 2000. Therefore, we estimate that the annualized pre-tax loss in long term support will be \$58 million.

We received \$48 million in universal service fund subsidies in 1998 and \$27 million in 1997. The amount received in 1998 was higher than normal because Puerto Rico Telephone Company included certain non-recurring costs when calculating the amount of such support. In October 1998, the FCC issued an order selecting a cost model for universal service and planned to select cost inputs

in the second quarter of 1999. Due to unforeseen delays, the FCC has moved the implementation date of the new universal service mechanism for nonrural carriers to January 2000. Our universal service program will be designed to complement the FCC program, however until we receive FCC action we cannot predict the amount of future subsidies.

As a result of changes in the regulatory environment, Puerto Rico's telecommunications market has become increasingly competitive. As of June 30, 1998, we held over 95% of the local wire-line market and our

43

&lt;PAGE&gt; 47

share of the on-island long distance market in Puerto Rico decreased from 98% in February to 63% in June 1999. We expect to experience an erosion of market share in the local market over time resulting from increased competition and regulatory changes. See "-- Six Months Ended June 30, 1999 Compared with Six Months Ended June 30, 1998."

Since February 1, 1999, customers can place long distance calls with any pre-subscribed carrier by dialing the number as opposed to having to dial a five-digit access code and the number. In addition, the Puerto Rico Telephone Authority and Telefonica Larga Distancia terminated their mutual non-competition covenants effective February 1, 1999. As a result, we are offering off-island long distance service, and Telefonica Larga Distancia is offering on-island long distance. In addition, some of our competitors, such as AT&T, Sprint and MCI Worldcom, have made investments in offering services to residential and business customers in Puerto Rico. See "Risk Factors -- We Face a Significant Increase in Competition" and "Business -- Regulation."

The acquisition agreements provide that we will not raise tariffs for basic residential service for three years.

As a result of the changes in regulation, the competitive environment and the terms of the acquisition, we have determined that regulatory accounting principles as set forth in SFAS No. 71 are no longer applicable to our operations. Accordingly, we have discontinued the application of SFAS No. 71 in conformity with SFAS No. 101 "Accounting for the Discontinuation of Application of SFAS No. 71." We have made an assessment of the cost of property, plant and equipment that will not be realized based on an analysis of the cash flows expected to be generated by the telephone plant and equipment over their remaining economic lives established in light of competitive trends and technology replacement. Consistent with the rest of the local exchange telephone industry, this assessment has resulted in the write-down of plant and equipment in the amount of \$198.5 million. A proportionate amount of this adjustment, which is approximately \$99.2 million, has been accounted for as a purchase price adjustment in accordance with the provisions of partial step-up accounting to reflect the fair market values of the assets acquired on March 2, 1999. The remaining \$99.2 million was recorded as an extraordinary charge in the consolidated statements of operations. The amount of this extraordinary charge was \$60.5 million, net of a tax benefit of \$38.7.

#### YEAR 2000 COMPLIANCE

##### GENERAL

The Year 2000 issue concerns the potential inability of information systems to properly recognize and process date-sensitive information beyond January 1, 2000, and has industry-wide implications. We have been addressing potential Year 2000 issues since the second quarter of 1997. This program is necessary because the Year 2000 issue could impact our telecommunication networks, systems and business processes. Because of our system conversion, enhancement activities and enterprise testing, we presently expect our networks, systems and processes to be Year 2000 compliant by the end of October 1999. Enterprise testing of our new

wireless billing system is expected to be complete in early November 1999. Although based on our progress to date, we presently expect that our Wireline and Wireless telecommunications businesses will be ready in sufficient time for the millennium rollover, we cannot know the actual effects of the Year 2000 issue on our business and operations until the Year 2000 arrives.

#### STATE OF READINESS

Our management considers systems preparation for Year 2000 to be a high priority and has a program in place to address Year 2000 compliance issues. Monthly reports are prepared in order to monitor our Year 2000 compliance program and are reviewed by our board of directors. We are communicating with customers, suppliers, financial institutions and others with whom we do business to communicate our status and to coordinate Year 2000 compliance. The inventory of our Year 2000 issues is complete and includes both information technology and non-information technology systems. As of September 30, 1999, our overall program is estimated to be 97% complete. Except for the new wireless billing system, all testing of equipment, products, and mission critical systems was completed in September 1999. Following standard industry practice, we have grouped our Year 2000 issues into several categories by order of priority.

44

<PAGE> 48

- Network operations and call routing are deemed to be most important and testing began in October 1998. This testing was completed in September 1999.
- Information technology and operational support systems such as billing and customer care follow next in priority. Conversion and testing of these systems were completed in September 1999 except for the wireless operational support system, which is expected to be complete in November 1999.
- System level testing of third-party supplier products and internally maintained software applications is in progress and is expected to be completed at the same time as the associated network and information technology systems.
- Enterprise or total company testing of all major processes began in November 1998 and was completed in September 1999, except for the wireless billing system, which is expected to be complete in early November 1999.

#### USE OF INDEPENDENT VERIFICATION AND VALIDATION

In order to independently verify the results of our effort to date, we have hired two independent contractors to perform a specialized scanning program check on our mainframe applications programs which have already been tested and converted and tested internally. We expect that this additional verification process and any necessary conversion and testing will be complete by the end of October 1999.

#### COST TO ADDRESS YEAR 2000 ISSUES

We have established a \$21 million expense budget for Year 2000 compliance, excluding costs relating to Celulares Telefonica's new billing system, of which approximately \$20.1 million had been spent as of September 30, 1999. We expense costs associated with our Year 2000 compliance program in the year they are actually incurred. We do not anticipate that we will incur significant operating expenses or be required to make substantial additional investments in our computer systems to be Year 2000 compliant.

#### RISKS OF YEAR 2000 ISSUES

We face a potential Year 2000 risk in connection with the billing system for Celulares Telefonica, which is expected to be customized, installed and tested by its third party developer in early November 1999. The new Year 2000 compliant billing system for Celulares Telefonica was developed by Amdocs (UK) Limited and is currently in use by other major wireless companies, including other affiliates of GTE Corporation, and is being customized for Celulares Telefonica by the developer. If the Celulares Telefonica system is not ready in time, Celulares Telefonica's billing system may experience significant Year 2000 problems. Celulares Telefonica is developing contingency plans to address this situation, including using specific modules of already certified year 2000 applications.

Other scenarios might include a possible but presently unforeseen failure of key supplier or customer business processes or systems. This situation could conceivably persist for some months after the millennium transition and could lead to possible revenue losses. Our present assessment of our key suppliers and customers does not indicate that this scenario is likely. As of August 31, 1999, we have successfully deployed a compliant network infrastructure.

#### CONTINGENCY PLANS

Contingency plans exist or are being developed for critical and non-critical systems. A major corporate-wide program is being implemented in conjunction with the GTE Corporation's Year 2000 Program Office. This program includes both contingency and business continuity planning.

Under GTE Corporation's umbrella program, we are bolstering our normal business continuity planning to address potential Year 2000 interruptions. We are also developing our plans with respect to possible occurrences immediately before, during, and after the millennium transition. These plans are currently 98% complete. The testing of the contingency plans is 96% complete and we expect to conclude testing by the end

45

<PAGE> 49

of October 1999. This contingency plan includes: business continuity planning; disaster recovery/emergency preparedness; millennium rollover planning; post millennium degradation tracking; a network and information technology "stabilization" period; employee availability and logistics backup planning; coordination with other telecommunications providers; a Year 2000 "war room" operation to provide high-priority recovery support, plans for key personnel availability, command structures and contingency traffic routing; and plans for round-the-clock, on-call repair teams.

#### THIRD PARTY ISSUES

We continue our surveys of significant third-party vendors, suppliers and customers whose systems, services or products are important to our operations. We have instituted a verification process to determine the Year 2000 readiness of these third-parties. This verification process includes reviewing test and other data of third-parties and engaging in regular conferences with these third-parties' Year 2000 teams. We believe that the systems, services or products supplied by third-parties are either Year 2000 compliant or are expected to be Year 2000 compliant by the end of the third quarter of 1999. However, we cannot control the activities of third parties and the non-compliance of third-party products and services could have a material adverse effect on our operations. Assuming Celulares Telefonica's new billing system is installed on time and performs properly, we do not presently anticipate that business operations will be disrupted or that customers will experience any significant interruption of services as a result of the millennium change.

## QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

## INTEREST RATE SENSITIVITY

The table below provides information about our long-term debt obligations as of June 30, 1999 which are sensitive to changes in interest rates. The table presents the estimated interest requirement for each of the next five years and in the aggregate thereafter as well as the related average interest rates.

&lt;TABLE&gt;

&lt;CAPTION&gt;

	INTEREST REQUIREMENT					
	1999	2000	2001	2002	2003	2004
	(IN THOUSANDS)					
<S>	<C>	<C>	<C>	<C>	<C>	<C>
Long-term Debt						
Fixed						
Senior Notes						
2002(1)(2).....	\$11,326	\$18,450	\$18,450	\$20,200	\$21,450	\$21,450
Interest						
Rate.....	6.15%	6.15%	6.15%	6.73%	7.15%	7.15%
Senior Notes						
2006(1).....	\$16,329	\$26,600	\$26,600	\$26,600	\$26,600	\$26,600
Interest						
Rate.....	6.65%	6.65%	6.65%	6.65%	6.65%	6.65%
Senior Notes						
2009(1).....	\$12,523	\$20,400	\$20,400	\$20,400	\$20,400	\$20,400
Interest						
Rate.....	6.80%	6.80%	6.80%	6.80%	6.80%	6.80%
Floating						
Five-year						
Revolving						
Credit						
Facility(3)(4)...	\$30,938	\$40,125	\$41,625	\$43,125	\$43,125	\$43,125
Average						
interest						
rate.....	7.425%	8.025%	8.325%	8.625%	8.625%	8.625%
364-day Revolving						
Credit						
Facility(3)(5)...	\$ 1,977	\$ --	\$ --	\$ --	\$ --	\$ --
Average						
interest						
rate.....	7.625%					

&lt;/TABLE&gt;

## Assumptions:

- (1) Interest has been calculated on a 360-day basis from the date of issuance (May 20, 1999) for 1999.
- (2) Interest has been calculated from May 20, 2002 and thereafter on the assumption that the notes are refinanced for an additional three years at a 7.15% interest rate.
- (3) Interest has been calculated using a projected interest rate based on LIBOR projections plus 100 basis points, plus a margin of .725 for the Five-Year Revolving Credit Facility and a margin of .925 for the 364-day Revolving Credit Facility.

- (4) Interest has been calculated from May 20, 2004 and thereafter on the assumption that the \$500 million outstanding is rolled over for an additional five years.
- (5) Interest for 1999 has been calculated based on the principal amount of \$91.1 million outstanding from March 2, 1999 through June 2, 1999 and \$26.1 million outstanding as of June 30, 1999. The principal amount became zero as the \$26.1 million was repaid in full on July 6, 1999.

47

&lt;PAGE&gt; 51

## UNAUDITED PRO FORMA CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## INTRODUCTION

The unaudited pro forma condensed financial information presented below reflects adjustments that give effect to:

- (i) the acquisition and related expenses, the payment of the special dividend and the incurrence of \$1.591 billion of debt, the accrual of management fees and a technology license royalty which are payable to subsidiaries of GTE Corporation (excluding the accrual of interest on the initial delayed payment) and the direct payment of income, unemployment, property and municipal taxes;
- (ii) the adoption of the partial step-up in accounting basis recorded under the purchase accounting provisions under EITF 88-16 which establishes a new basis of valuation for the assets and liabilities acquired in the acquisition and the effect of Telecomunicaciones de Puerto Rico becoming a taxable enterprise;
- (iii) the discontinuation of regulatory accounting; and
- (iv) an anticipated net loss in revenues, estimated at approximately \$70 million on an annualized basis in 2000, from losing the National Exchange Carrier Association long-term support subsidies based on the adoption of a price cap mechanism for common line access under applicable FCC regulations. The change is not expected to take effect until sometime in the first half of 2000.

The unaudited pro forma condensed consolidated statements of income give effect to the adjustments as if the transactions they relate to had occurred as of January 1, 1998. An unaudited pro forma balance sheet has not been presented as the transaction has already been reflected in the June 1999 balance sheet.

The unaudited pro forma condensed financial information has been included for comparative purposes only. It is based upon our financial statements and those of our predecessors and should be read in conjunction with such financial statements and related notes, which are included elsewhere in this prospectus. The pro forma information does not purport to be indicative of the results which would have occurred if the acquisition had occurred on the dates or for the periods indicated or which may occur in the future, nor to consider all effects of the acquisition and privatization.

The pro forma results for the year ended December 31, 1998 do not include a \$26.1 million non-recurring charge to earnings recorded in March 1999 associated with the establishment of the employee stock ownership plan, which charge is included in the pro forma results for the six months ended June 30, 1999. The pro forma adjustments do not include a non-recurring charge anticipated to be recorded in 1999, related to the implementation of a voluntary early retirement program. This program is expected to produce a charge in the range of \$143 million to \$173 million. The pro forma condensed financial information does not



adjust for other potential favorable and unfavorable changes in our business, including certain of those described in the "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Factors Affecting the Company's Future Financial Results" and the June 30, 1999 financial statements included elsewhere in this prospectus.

48

&lt;PAGE&gt; 52

## TELECOMUNICACIONES DE PUERTO RICO, INC. AND SUBSIDIARIES

UNAUDITED PRO FORMA CONDENSED CONSOLIDATED STATEMENT OF INCOME  
FOR THE YEAR ENDED DECEMBER 31, 1998

<TABLE>  
<CAPTION>

	HISTORICAL PREDECESSORS	PRO FORMA ADJUSTMENTS TO REFLECT THE ACQUISITION AND THE OFFERING OF THE OLD NOTES	PRO FORMA COMPANY
		(IN THOUSANDS)	
<S>	<C>	<C>	<C>
Revenues and Sales.....	\$ 1,270,684	\$ (70,000) (1)	\$1,200,684
Operating Costs and Expenses, Excluding Depreciation and Amortization.....	746,890	52,000 (2) (3,729) (3) 38,000 (4)	833,161
Depreciation and Amortization.....	296,493	15,700 (5)	312,193
Operating Costs and Expenses.....	1,043,383	101,971	1,145,354
Operating Income.....	227,301	(171,971)	55,330
Interest Income (Expense), net.....	2,479	(800) (6) (101,350) (7) (700) (8)	(100,371)
Other Income (Expense), net.....	(5,413)		(5,413)
Income (Loss) Before Taxes.....	224,367	(274,821)	(50,454)
Income Tax Provision (Benefit).....		(19,677) (9)	(19,677)
Net Income (Loss).....	\$ 224,367	\$ (255,144)	\$ (30,777)

&lt;/TABLE&gt;

See accompanying Footnotes to the Unaudited Pro Forma Condensed Consolidated Financial Statements.

49

&lt;PAGE&gt; 53

## TELECOMUNICACIONES DE PUERTO RICO, INC. AND SUBSIDIARIES

UNAUDITED PRO FORMA CONDENSED CONSOLIDATED STATEMENT OF INCOME  
FOR THE SIX MONTHS ENDED JUNE 30, 1999

<TABLE>  
<CAPTION>

	HISTORICAL FOR THE 1999 PERIOD			F ADJU RE ACQU THE C
	COMPANY MARCH 2, TO JUNE 30,	PREDECESSOR JANUARY 1, TO MARCH 1,	SUBTOTAL	
			(IN THOUSANDS)	
<S>	<C>	<C>	<C>	<C>
Revenues and Sales.....	\$446,983	\$223,300	\$670,283	\$
Operating Costs and Expenses, Excluding Depreciation and Amortization.....	287,274	172,032	459,306	
Depreciation and Amortization....	99,484	50,393	149,877	-
Operating Costs and Expenses.....	386,758	222,425	609,183	-
Operating Income.....	60,225	875	61,100	
Interest (Income) Expense, net...	29,336	(407)	28,929	
Other Income, net.....	1,285	569	1,854	-
Income (Loss) Before Taxes.....	32,174	1,851	34,025	
Income Tax Provision (Benefit)...	11,729	--	11,729	-
Net Income (Loss) Before Extraordinary Charge.....	\$ 20,445	\$ 1,851	\$ 22,296	\$

</TABLE>

See accompanying Footnotes to the Unaudited Pro Forma Condensed Consolidated  
Financial Statements.

50

<PAGE> 54

TELECOMUNICACIONES DE PUERTO RICO, INC. AND SUBSIDIARIES

FOOTNOTES TO UNAUDITED PRO FORMA  
CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEAR ENDED DECEMBER 31, 1998 AND THE SIX MONTHS ENDED JUNE 30, 1999

The pro forma results of operations reflect the effects of the adoption of partial step up accounting and the change in status of the Company which has become a tax paying enterprise with the completion of the acquisition.

The following pro forma adjustments have been made to the unaudited pro forma condensed consolidated financial statements:

(1) Reflects an anticipated loss in revenues, estimated at approximately \$70 million on an annualized basis in 2000, from losing the National Exchange Carrier Association long-term support subsidies based on the adoption of a price cap mechanism for common line access under applicable FCC regulations. The change is not expected to take effect until

sometime in the first half of 2000.

(2) Prior to the acquisition, Puerto Rico Telephone Company paid a cash dividend to the Puerto Rico Telephone Authority in an amount equal to its net income plus noncash amortization and depreciation expense. Due to this payment, Puerto Rico Telephone Company was not required to pay municipal and property taxes or Puerto Rico income taxes. As a result of the acquisition, Puerto Rico Telephone Company is now responsible for the direct payment of municipal and property taxes and income taxes. We estimated the amount reflected for municipal and property taxes by applying the statutory tax rate of each municipality by the appraised value for each property and municipality, determined in accordance with guidelines established by the Puerto Rico government and the municipalities.

The \$52 million pro forma adjustment to Operating Costs and Expenses, Excluding Depreciation and Amortization for the year ended December 31, 1998 and the \$8.7 million pro forma adjustment to Operating Costs and Expenses, Excluding Depreciation and Amortization for the six months ended June 30, 1999, reflect estimated municipal and property taxes for the period prior to the acquisition on March 2, 1999.

(3) Prior to the acquisition, the Company was amortizing unrecognized prior service costs related to its pension and other past employment benefit plans to Operating Costs and Expenses, Excluding Depreciation and Amortization. As a result of partial step-up accounting adjustments recorded at the time of the acquisition, prior service cost amortization for 50% of these liabilities will not occur in periods subsequent to March 2, 1999.

The \$3.7 million pro forma adjustment to Operating Costs and Expenses, Excluding Depreciation and Amortization for the year ended December 31, 1998 and the \$.7 million pro forma adjustment to Operating Costs and Expenses, Excluding Depreciation and Amortization for the six months ended June 30, 1999 reflect the prior service cost amortization accrued in partial step-up accounting at the time of the acquisition.

(4) Subsequent to the acquisition, a management and technology license fee is payable by the Company to the GTE Group. The \$38 million pro forma adjustment to Operating Costs and Expenses, Excluding Depreciation and Amortization for the year ended December 31, 1998 and the \$3.9 million pro forma adjustment to Operating Costs and Expenses, Excluding Depreciation and Amortization for the six months ended June 30, 1999 reflect the estimated management fee and technology license fee for periods subsequent to the acquisition. The estimates are based on a percentage of operating income plus noncash amortization and depreciation.

(5) The \$15.7 million pro forma adjustment for the year ended December 31, 1998 and the \$2.3 million pro forma adjustment for the six months ended June 30, 1999 reflect the net effect of the partial step-up in basis required under the provisions of EITF 88-16 recorded at the time of the acquisition on March 2, 1999 (primarily goodwill and other long-term intangibles.).

As a result of the acquisition, the Company recorded goodwill and other long-term intangible assets (primarily franchises, licenses and brand name) of \$268.0 million. The amounts allocated to goodwill and other long-term intangible assets are being amortized on a straight-line basis over a period of 25 years.

The Company also recorded intangibles of \$18.2 million related to the customer base. The amount allocated to the customer base is being amortized over a period of three years to reflect the period over which revenue is expected to be generated by customers acquired as of the acquisition date. We monitor the loss of customers due to attrition and plan to adjust amortization if changes in attrition rates are experienced.

51

&lt;PAGE&gt; 55

(6) Reflects the amortization of underwriting discounts and expenses related to the offering of the old notes over a ten-year period.

(7) Reflects interest expense, calculated at a rate of 6.37% per year, on the outstanding debt balance of \$1.591 billion. The 6.37% rate reflects the floating rate in effect on the acquisition date. A change in the interest rate of 0.25% would result in a change of \$4.0 million in annual interest expense.

(8) Reflects fees associated with the employee stock ownership plan that was established at the time of the acquisition.

(9) The \$19.7 million pro forma adjustment to the Income Tax Provision for the year ended December 31, 1998 and the \$24.6 million pro forma adjustment to the Income Tax Provision for the six months ended June 30, 1999 reflect the adjustments required to record Puerto Rico income taxes at a statutory rate of 39% for each respective period on a pro forma basis considering the imposition of income taxes and the tax effect of the pro forma adjustments.

52

&lt;PAGE&gt; 56

## BUSINESS

### OVERVIEW

We are the largest telecommunications service provider in Puerto Rico and one of the ten largest local exchange carriers in the United States as measured by access lines in service. We have been providing telecommunications services in Puerto Rico since 1914. We are a diversified telecommunications company, providing local, on-island and off-island long distance services, wireless telephony and paging services and telecommunications equipment to our residential and business customers. We also provide network access and billing services to wireline carriers and wireless operators in Puerto Rico. We operate the island's largest network of public pay telephones and market Puerto Rico's primary telephone directory.

We invested over \$1.7 billion from 1994 to 1998 primarily to expand and enhance our wireline and wireless communications networks. Our transmission network is 100% digital, encompasses over 73,000 fiber miles and currently uses SONET technology in a fiber optic ring configuration with speeds up to OC-48. This network provides the principal transmission medium for most public and special facilities circuits and supplies direct fiber optic connections to more office buildings than any other service provider on the island. Our cellular network utilizes the IS-136 standard with time division multiple access digital technology and provides island-wide coverage in Puerto Rico.

We have more than 1.2 million regular access lines in service, including 962,000 residential lines and 290,000 business lines. We have the leading market share of the local wireline market (approximately 95% in June 1999) and the

on-island long distance market (approximately 63% in June 1999) in Puerto Rico. In addition, we have an estimated 35% share of the cellular market and a leading share of the paging market. On February 1, 1999 we began offering off-island long distance services.

The market share data in this prospectus has been determined based on access lines in service for local telephony; minutes of use for long distance services; and subscribers for wireless telephony, paging, and Internet services. The wireless telephony market includes the total market for personal communications services as well as traditional cellular services.

#### STRATEGY

We seek to enhance our leadership position in the Puerto Rico telecommunications market by stimulating demand for our core telephony services and continuing to extend our franchise in the growth areas of wireless and data services. We plan to achieve these goals with innovative marketing strategies and by providing superior service, value and convenience relative to our competitors. We intend to capitalize on Puerto Rico's increasing wireline and wireless penetration to grow our business. We expect to enhance this growth by spurring demand for value-added services such as custom calling options, caller-ID, voice messaging and other value-added services. We will leverage our large customer base to penetrate the significant off-island long distance market recently opened to us. We will also pursue opportunities with business and government customers to provide end-to-end communications solutions and to position Telecomunicaciones de Puerto Rico as the leading provider in the emerging market for Internet and enhanced data services in Puerto Rico.

We are in the process of implementing key strategic initiatives to achieve these goals. The principal elements of these initiatives are to:

#### - STRENGTHEN OUR MARKETING FOCUS

We plan to capitalize on marketplace opportunities in Puerto Rico through segment-based marketing and by leveraging our brand recognition as Puerto Rico's leading telecommunications company. We will target high value customers in both residential and business markets and design products and services targeted specifically to meet their needs. We are developing retention programs for our most profitable customers and plan to expand the sale of value-added and Internet services.

53

<PAGE> 57

We believe we can leverage our island-wide capabilities and differentiate our services from the fragmented service offerings of our competitors. As the only full service telecommunications provider in Puerto Rico, we plan to offer customized packages that include local, enhanced network products/services, long distance, cellular, paging, data and Internet services, and our new off-island long distance service. We believe that by segmenting our customer base, bundling our product and service offerings and implementing value-based pricing, we will be able to retain and improve our market share and operating margins.

#### - IMPROVE OUR SYSTEMS AND PROCESSES

We are taking steps to improve the delivery of services by implementing better processes for customer service, product development, technology implementation and service delivery. We believe that by becoming a more efficient telecommunications provider, we will increase customer satisfaction and profitability.

Many of our current processes are manually intensive and can be streamlined to reduce processing complexity, delivery time and cost. We believe that the majority of our core business processes can be improved. For example, our sales

and repair operations are decentralized, with 16 commercial sales offices and 24 repair centers that do not share a linked information system. We intend to rationalize these resources and to operate them using an integrated delivery and customer care system.

We are redesigning our information systems to facilitate implementation of our strategy. For example, our current billing systems do not permit the efficient billing of multiple services. As a first step, we have ordered a new billing system for our wireless telephony business which we expect to be in place in the fourth quarter of 1999. This new system will facilitate our strategy of segmenting customers, offering bundled services and providing customized billing options. We plan to link this system to new and existing information systems for our other businesses.

#### - LEVERAGE OUR RELATIONSHIP WITH GTE CORPORATION

We will utilize GTE Corporation's experience, resources and capabilities to improve our operating efficiency and profitability. For example, GTE Corporation has already begun to assist us in the procurement of products and services from key GTE Corporation vendors at prices more favorable than we could otherwise obtain. We are also working with GTE Corporation to assess and re-engineer core business processes such as order-entry, inventory management, service provisioning and customer care. Discussions are also underway to subcontract some key elements of these processes to GTE Supply, an established provider of logistics and supply-line services to the telecommunications industry.

GTE Corporation will provide support for emerging technologies, advanced systems implementation, and marketing expertise. We plan to obtain network planning tools from GTE Corporation for both wireline and wireless systems and are also working with GTE Internetworking to develop and offer integrated data and Internet-related service to our larger business and municipal government customers. In addition, our relationship with GTE Corporation, one of the leading wireless telephony providers in the mainland United States, will enable us to expand significantly our roaming capabilities in the mainland U.S. market.

#### - MAKE SERVICE QUALITY AND CUSTOMER RESPONSIVENESS PRIORITIES FOR OUR WORKFORCE

We are promoting a more collaborative workforce and are working with our employees to improve our service orientation and operations efficiency. In support of this strategy we expect to offer increased training, introduce more incentive-based compensation plans and negotiate changes in work rules. An example of management's commitment to this goal was the creation of the Telecomunicaciones de Puerto Rico employee stock ownership plan whereby for the first time, our employees obtained an ownership position in our company. We also expect to develop specific improvement programs to measure and reward actual performance.

54

<PAGE> 58

### LOCAL SERVICES

#### OVERVIEW

Local services include basic voice, telephone rental, value-added services, special services, Internet and data access, and installation services. The following table shows our breakdown of residential and business access lines in service, excluding public phones, direct inward dialing business lines, wide area telecommunications services lines, private branch exchange trunks, and cellular and paging customers:

#### ACCESS LINES IN SERVICE

<TABLE>  
<CAPTION>

	JUNE 30, 1999	YEAR ENDE ----- 1998 -----
	(IN THOUSANDS	EXCEPT PE
<S>	<C>	<C>
Residential Lines.....	962	947
Business Lines.....	290	284
	-----	-----
Total Access Lines in Service.....	1,252	1,231
	=====	=====
Growth.....	1.7%	0.8%

</TABLE>

Wireline penetration in Puerto Rico was 77% at December 31, 1998 as compared with penetration of over 90% in the mainland United States.

#### BASIC VOICE SERVICE

Basic voice service is the most significant component of the local services category, representing \$352 million in revenues in 1998, or 28% of total revenues and \$241 million in revenues, or 36% of total revenues for the period ended June 30, 1999. Our basic voice service revenues have increased with the growth in the number of access lines in service. The growth in access lines for 1996 and 1997 resulted from a strong local economy and increasing demand for telecommunications services by businesses, as well as strong residential demand for second lines. Line growth slowed in 1998 because of the impact of Hurricane Georges and the 41-day work stoppage.

To establish basic local rates, communities in Puerto Rico are grouped into five categories based on the number of lines served within a given geographical area. For example, the largest cities (those with densities of more than 40,000 lines) carry flat rates for unlimited usage of \$18.80 per month, while small, typically rural communities (less than 1,000 lines) carry flat rates for unlimited usage of \$7.60 per month. Residential rates for unlimited usage average \$13.60 per month. The pricing scale has not changed since 1982 and, under the terms of the acquisition, basic rates for residential customers cannot be increased for three years after the acquisition. The business rate scale is narrower and rates for basic service range from \$34.60 to \$36.65 per month and average, including usage, \$46.00 per month. These rates exclude the \$3.50 and \$6.00 per month subscriber line access charges for residential and multi-line business customers, respectively, that are set by the FCC and are included in access revenues.

Our principal competitor in the local service business has been Centennial, the first facilities-based competitive local exchange carrier in Puerto Rico. Centennial entered the San Juan market in 1997 with a fiber optic network targeted at business customers. Centennial also began marketing a fixed wireless local loop service to high volume on-island long distance residential users throughout the island in 1997.

#### TELEPHONE RENTAL

Approximately 90% of small, single line businesses and 63% of residential customers rent telephones which generated approximately \$28 million in revenues in 1998 and approximately \$14 million in revenues for the period ended June 30, 1999. Telephone rental revenues for the entire residential and business customer base average \$2.00 and \$2.60 per customer per month, respectively. Rental levels are high compared to mainland telecommunications companies as we still own the inside wire on the customer premises and therefore are still responsible for maintenance of inside wires and rental phones. Mainland telecommunica-

&lt;PAGE&gt; 59

tions companies saw consumers shift from renting to purchasing phones from retail outlets during the 1980's as consumers became responsible for instrument repairs.

We are considering a plan to transfer inside wire and telephone repair responsibility to consumers and we believe that this would be economically advantageous despite the fact that rental revenues will likely decrease over time. Repair fees and repair maintenance contracts could potentially replace the telephone rental revenue stream. More important, however, would be the reduction of inventory costs for rental equipment and the expected reduction in operating expenses as the free repair policy has had the effect of producing multiple visits per customer repair. We believe that the adoption of this new policy will not result in a charge to earnings as we began expensing inside wire costs when the industry changed its commercial practices.

#### VALUE-ADDED SERVICES

Value-added services include over fifteen voice features, such as caller ID, call return, call waiting, 3-way calling and voice mail. Value-added service revenues increased 30% from \$27 million in 1997 to \$35 million in 1998 and were \$19 million for the period ended June 30, 1999. The most popular services are caller ID, call return and call waiting. Value-added services are sold individually or in packages with prices ranging from \$1.50 to \$7.50 per month. Residential customer acceptance of these services has been strong. Of the 906,525 customers whose lines are equipped for custom calling features approximately 39% have subscribed for at least one custom calling feature and of the 805,000 customers whose lines are equipped for class services, such as return call and caller ID, over 33% have subscribed for at least one class service feature.

#### SPECIAL SERVICES

Special services include private lines marketed to businesses primarily for data transport. For 1998, these lines contributed \$12 million in the local revenue category with an additional \$18 million included in the long distance category for private line carriage beyond the local central office exchange. Management believes that strong demand for these lines exists from both large and medium-sized business customers. We expect to complete an ATM Network in 1999 which will enhance our ability to offer broad bandwidth, tailored, cost effective services to our business customers.

#### INTERNET AND DATA SERVICES

We launched our Internet services in late 1996 by offering unlimited dial access to our customers in the San Juan metropolitan area and have expanded our service to 43 additional towns outside the metropolitan area. During 1997, we introduced dedicated Internet access to business customers through the use of private lines. Internet services contributed approximately \$4 million to our revenues in 1998.

We currently have approximately 2,500 modems which can provide service to more than 25,000 customers and 120 ports for dedicated access. We are improving our platform by adding 2,600 additional modems across 6 nodes and doubling the number of T-1 connections to the main Internet backbone in the United States from 5 to 10.

#### NETWORK ACCESS SERVICES

Network access services include services provided to inter-exchange carriers, other local exchange carriers, cellular and personal communications service operators and paging companies for the origination and termination of



calls to and from Puerto Rico Telephone Company's local customers. These operators pay an access fee to Puerto Rico Telephone Company based on tariffs or specific interconnection agreements which have a duration of one, two or three years. We also collect network access fees directly from our customers in the form of FCC-mandated line charges.

56

&lt;PAGE&gt; 60

We recorded total network access revenues of \$300 million in 1998. The principal components of network access revenues are:

- \$170 million from long distance carriers;
- \$48 million from the Universal Service Fund, the federal subsidy provided to cover revenue requirements for a high-cost regulated telecommunications company;
- revenues from subscriber lines and end-users of \$56 million;
- special access revenues of \$12 million;
- cellular and beeper access revenues of \$7 million; and
- intra-island access revenues of \$7 million.

The long-term support subsidy relates to the common line pool, which is managed by the National Exchange Carrier Association. The revenues received from National Exchange Carrier Association are based on our participation in revenue pools with other telephone companies funded by access charges authorized by the FCC. These pooled amounts are subsequently divided among the various telephone companies based upon their respective allocations of costs and investments in providing interstate service.

GTE Corporation does not participate in the National Exchange Carrier Association common line pool, but instead generates common line revenues from several access elements. These elements include explicit pre-subscribed inter-exchange common carrier line charges assessed on a per line basis and increased end-user subscriber line charges. GTE Corporation also assesses a per minute carrier common line charge established under an FCC price-cap formula if revenues generated from the first two elements are insufficient to cover revenue requirements. GTE Corporation is subject to price-cap regulation, a regulatory regime that under FCC rules must apply to all of GTE Corporation's local exchange subsidiaries. Consequently, Puerto Rico Telephone Company is required to exit the National Exchange Carrier Association pool and adopt price-cap based access charges. The FCC provides a 12-month period after the date of the acquisition for the transition to price-caps. For additional information about the effect of this change, see "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Factors Affecting Our Future Financial Results."

#### PUBLIC PHONES

The decline in public phone revenues from \$12 million in 1997 to \$9 million in 1998 resulted from the entrance of new payphone operators in the market. We have historically taken a universal service approach to the pricing of this service, as evidenced by a price of 10 cents for a call of unlimited duration. However, several payphone operators have challenged our historical pricing practices before the Telecommunications Board, arguing that the wireline business is subsidizing public phones.

These new competitors have begun charging higher prices, which currently are 25 cents for each 3 minutes for the duration of a call. We also adopted this price policy on January 15, 1999 for new, "intelligent" phones. Intelligent